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IN THE

Supreme Court of the United States

AMERICAN ELECTRIC POWER COMPANY, INC., *et al.*,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Sixth Circuit erred by applying an expanded "economic substance" doctrine to trump the detailed statutory framework that Congress crafted to regulate the availability of tax benefits for purchases of corporate owned life insurance ("COLI") policies and other life insurance policies.

2. Whether the Sixth Circuit erred by holding that a transaction that results in a loss in the absence of congressionally provided tax benefits is lacking in "economic substance" simply because the transaction is not profitable in the absence of the tax benefits.

PARTIES TO THE PROCEEDING

The parties include the following:

American Electric Power Co., Inc., et al., Petitioners

American Electric Power Co., Inc., Petitioner

American Electric Power Service Corp., Petitioner

Kingsport Power Co., Petitioner

Columbus Southern Power Co., Petitioner

Indiana-Michigan Power Co., Petitioner

Appalachian Power Co., Petitioner

Ohio Power Co., Petitioner

Conesville Coal Preparation Co., Petitioner

Southern Ohio Coal Co., Petitioner

Central Ohio Coal Co., Petitioner

Central and South West Corporation, Petitioner

Central Power and Light, Petitioner

Public Service Company of Oklahoma, Petitioner

Southwestern Electric Power Company, Petitioner

West Texas Utilities Company, Petitioner

United States of America, Respondent

RULE 29.6 STATEMENT

Petitioner, American Electric Power Co., Inc., is the parent corporation of the subsidiaries listed above. No publicly held company owns 10% or more of the stock of any Petitioner.

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OPINIONS BELOW

The opinion of the United States District Court for the Southern District of Ohio (App. B.) is published at 136 F. Supp. 2d 762. The Sixth Circuit's opinion (App. A.) is published at 326 F.3d 737.

STATUTORY PROVISIONS INVOLVED

The provisions of Internal Revenue Code ("I.R.C." or "Code") sections 163, 264, 7702 and 7702A involved in this case are reproduced at Appendix D.

JURISDICTION

The Sixth Circuit entered judgment on April 28, 2003, and denied a petition for panel rehearing on July 9, 2003. App. C. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

1. The Sixth Circuit opinion in this case constitutes a striking expansion of the judicially created "economic substance" doctrine in a manner that disregards Congress's intent and contradicts longstanding precedents of this Court and several United States courts of appeals. First, the Sixth Circuit's opinion extends the economic substance doctrine far beyond its limited judicial roots in *Knetsch v. United States*, 364 U.S. 361 (1960), where the doctrine was used as a last resort to fill a statutory vacuum, and instead applies the doctrine to "trump" the detailed framework of tax statutes that Congress carefully constructed to regulate the availability of tax benefits for life insurance policy purchases, including corporate owned life insurance (COLI) of the type involved in this case. Over thirty years ago, the Solicitor General, in a filing with this Court, acknowledged that the longstanding controversy over the application of the economic substance doctrine to transactions like the purchase of COLI by American Electric Power Company, Inc. ("AEP") was "rendered moot" by the detailed statutes on which AEP relies to claim its

disputed deductions. Brief for Respondent in Opposition in *Golsen v. Commissioner* at 5 (Oct. 12, 1971) (No. 71-368) (Government's Opp'n.), *cert. denied*, 404 U.S. 940 (1971). Second, the opinion below holds that the life insurance policies in issue here lack economic substance despite the fact that they transfer real insurance risk, disregarding this Court's teaching that risk transfer is the *sine qua non* of real and substantive insurance arrangements. *Helvering v. Le Gierse*, 312 U.S. 531 (1941); *United States v. Consumer Life Ins. Co.*, 430 U.S. 725 (1977). Third, the Sixth Circuit's decision conflicts with two Ninth Circuit opinions by holding that, even though the transaction in dispute is granted a legislative tax subsidy, it lacks economic substance because it would not be profitable on a "before-tax" basis. *Sacks v. Comm'r*, 69 F.3d 982 (9th Cir. 1995); *Shirar v. Comm'r*, 916 F.2d 1414 (9th Cir. 1990).

2. AEP, one of the largest electric utility companies in the United States, is regulated by various state public utility commissions and the Federal Energy Regulatory Commission. App. B. at 30a.

In 1990, AEP sought to solve a non-tax problem caused by new accounting rules applicable to medical benefits provided to retired employees. Under the new rules, AEP was required to accrue during its employees' working lives the cost of their post-retirement medical benefits. This new accrual rule increased AEP's current expenses and reduced its net earnings. To alleviate this problem, AEP sought investments to offset these increased costs. While an obvious source of additional earnings lay in increased rates charged to its customers, AEP doubted that regulators would permit AEP to pass on to ratepayers the entire amount of the increase in its post-retirement medical benefits expense. In order to enhance the possibility of obtaining regulatory approval for rate increases, AEP adopted a three-part strategy. App. B. at 30a.

First, AEP purchased from a major life insurance company a large block of commercially available, individual life insurance

policies (corporate owned life insurance or COLI) on the lives of its employees. AEP expected these COLI policies to generate earnings that would partially offset its increased post-retirement medical benefits expense and thereby reduce the amount of rate increases that AEP would otherwise require to offset that expense. The purchase of life insurance policies for investment purposes is commonplace, as is the use of life insurance to finance employee benefits. Under such an "aggregate cost recovery" plan, with "the tax-free recovery of death benefits, the hope is that the total death benefits payments will cover most or all of the postretirement benefits promised." Kenneth Black, Jr. & Harold D. Skipper, Jr., *Life & Health Insurance* 409 (13th ed. 2000). Many states have enacted laws permitting such plans, including Ohio, where AEP is located. Oh. Rev. Code Ann. § 3911.091 (2003).

Second, AEP created a new account in its existing voluntary employees' beneficiary association ("VEBA") trust fund dedicated to funding irrevocably its post-retirement medical benefits. Third, AEP asked its regulators for rate increases, justified by and conditioned on AEP's undertaking to contribute annually to the VEBA its earnings from the COLI policies and from the requested rate increases. AEP's strategy was reviewed and approved by its federal and state regulators. App. B. at 37a-38a. The Public Utilities Commission of Ohio issued a staff report commending AEP's plan and complimenting AEP on its actions. Jt. App. at 509.[1] The trial court below found that AEP's rate-relief strategy "was a proper business purpose." App. B. at 80a.

3. The COLI policies that AEP purchased are commercial life insurance policies, issued and administered by major insurance companies unrelated to AEP (Mutual Benefit Life Insurance Company ("MBL") and Hartford Life Insurance

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1. References to "Jt. App." are to the Joint Appendix filed with the United States Court of Appeals for the Sixth Circuit on March 22, 2002.

Company ("Hartford")).[2] The policies, which were approved for sale by insurance regulators in Ohio and 42 other states and offered for sale nationwide (Jt. App. at 103), contain typical insurance provisions found in many permanent life insurance policies.

AEP's COLI policies produced significant economic consequences to various parties affected by the transaction. As for AEP, over the period from 1990 to 1998, it paid annual premiums of $16,667 per employee (creating substantial cash values) and received death benefits of $184 million. Jt. App. at 671, 790. Over that time period, AEP used policy loans and internal policy funds to pay some premiums. In addition, AEP paid over $343 million in out-of-pocket cash toward the cost of the policies. Jt. App. at 1087.

The insurance company reported as income the premiums and policy loan interest paid by AEP, reported the policy loans as assets, and reported the policy cash values as liabilities. Jt. App. at 1400-07, 1287-92. The insurance company assumed mortality and investment risk under the policy guarantees, and shared that risk with other insurance companies by entering into reinsurance agreements. Jt. App. at 106-07. Insurance regulators examined and approved the policies, as well as the insurance company's administration and financial reporting with respect to the policies. The COLI program also had economic effects on AEP's employees, whose previously unfunded post-retirement benefits were in part funded by COLI policy earnings contributed to the VEBA. Lastly, because AEP's regulators approved AEP's ratemaking proposals, the COLI program had an economic impact on AEP's ratepayers, whose utility billings were favorably affected.

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2. MBL issued the life insurance policies, but subsequently, upon entering into rehabilitation, transferred the policies by assumption reinsurance to Hartford. Thereafter, Hartford administered the policies. In this petition, MBL and Hartford will be referred to as the "insurance company."

The government concedes all of the foregoing non-tax, economic effects, admitting that AEP's policies "were commercial life insurance policies sold by independent insurers and approved by state regulators, created reciprocal obligations, required actual out-of-pocket payments of over $343 million, generated $184 million in death benefits, were reported for federal and state purposes and had various other effects on taxpayer, MBL, Hartford, regulators, taxpayer's ratepayers, its VEBA, and employees." Brief for Appellee at 24 (filed Apr. 18, 2002) (Sixth Circuit No. 01-3495) ("Government's Br.").

4. Over the years, Congress has enacted many federal income tax provisions that place restrictions on the design of life insurance policies. Certain of these provisions implement Congress's decision to provide (on a limited basis) a tax subsidy to life insurance policies. The tax subsidy arises because the interest that the insurance company credits to a life insurance contract's policy value (the so-called "inside buildup"), while deductible by the insurance company, is not taxed to the policyholder. I.R.C. §§ 7702 and 101. Other statutory provisions implement Congress's decision to limit the terms on which policies enjoying the tax subsidy can be purchased and financed. Historically, policyholders have systematically used borrowing, withdrawals from policy value, and policyholder dividends to pay premiums. Such plans often are referred to as "minimum premium" or "minimum deposit" plans. As described below, Congress has enacted various statutes to place limits on the purchase of tax-subsidized life insurance on a tax-advantaged, minimum deposit basis.

Congress's treatment of life insurance is to be contrasted to other situations, in which Congress has flatly prohibited the acquisition of tax-subsidized investments on a tax-advantaged basis. For example, if tax-exempt bonds are acquired with indebtedness, the interest on the debt is not deductible. I.R.C. § 265. In the case of life insurance, however, Congress decided not to impose a similar, blanket prohibition,

but instead to create a more nuanced statutory regime that allows, but tightly regulates, access to the life insurance tax subsidy on a tax-advantaged basis. I.R.C. §§ 264, 7702, 7702A. As demonstrated below, AEP's COLI policies comply with all of these statutory provisions.

Code § 7702 was enacted in 1984 to limit the size of the tax subsidy granted to life insurance policies. It does so by excluding from the definition of a "life insurance contract" policies that have excessively large cash values (which, in turn, are credited with excessive inside buildup) but that provide relatively small levels of life insurance protection. AEP's policies qualify as life insurance contracts under Code § 7702. Jt. App. at 99. As a result, both the interest credited to AEP's policy values (*i.e.*, the "inside buildup"), and the death benefits paid to AEP, qualify to be excluded from AEP's taxable income.

Code § 264 was amended in 1964 to limit the ability of policyholders to systematically borrow to purchase tax-subsidized life insurance. I.R.C. § 264(c)(1). The provision creates a "safe harbor" under which policy loan interest is deductible, but only if money is borrowed to pay premiums in no more than three of the first seven policy years. In compliance with Code § 264(c)(1), AEP restricted its use of policy loans, obtaining policy loans (and using them to pay annual premiums due) only in the first three policy years. The Sixth Circuit acknowledged that AEP's COLI plan "fits neatly within" the safe harbor rule. App. A. at 6a.

Code § 264 was amended again in 1986 to limit the amount of indebtedness that policyholders can incur to acquire tax-subsidized life insurance. Under the amended provision, when policy loans are used to acquire life insurance, interest is deductible only on indebtedness not exceeding $50,000 per insured life. In compliance with this provision, AEP restricted its borrowing to $50,000 per insured.

Code § 7702A was enacted in 1988 to limit the ability of policyholders to receive tax-free under Code § 72 withdrawals from policy value and policyholder dividends to purchase tax-subsidized life insurance. Under Code § 72, withdrawals from policy value and policyholder dividends generally are excluded from the policyholder's taxable income, unless they exceed the policyholder's basis or "investment in the contract" (premiums paid, less prior amounts received). This "basis first" rule permits policyholders to enjoy the economic benefit of inside buildup by allowing access to that buildup, through receipt of withdrawals and dividends, without immediate tax effect. Code § 7702A limits this "basis first" rule, making it applicable only to policies that accumulate policy values relatively slowly during the first seven policy years, and that (in turn) make available relatively smaller amounts of withdrawals and dividends during the first seven policy years. AEP's COLI policies comply with Code § 7702A.

In 1996, Congress determined that interest should no longer be deductible on COLI policy loans like AEP's, beginning with the year 1996.[3] Over a three-year phase-out period (1996 to 1998), Congress allowed interest deductions for COLI policy loans with respect to a maximum of 20,000 insured lives per policyholder, computed using a limited interest rate. In 1996, the tax year at issue in this case, AEP complied with HIPAA, claiming an interest deduction on COLI policy loans with respect to 20,000 insured lives, calculated using the HIPAA-specified interest rate.

Notwithstanding the fact that AEP's COLI policies complied with Code §§ 264, 7702 and 7702A, as well as with the HIPAA transition rule, the Internal Revenue Service denied in full the deductions that AEP claimed with respect to interest on its COLI policy loans for the year 1996.

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3. Health Insurance Portability and Accountability Act of 1996, § 501, Pub. L. No. 104-191, 110 Stat. 1936, 2090-93 ("HIPAA").

5. The United States District Court for the Southern District of Ohio had jurisdiction in this case under 26 U.S.C. § 7422 and 28 U.S.C. § 1346(a)(1). In the district court, the government contended that AEP's claimed policy loan interest deductions were properly disallowed because AEP's COLI program lacked "economic substance." The district court agreed, analyzing the economic substance of the COLI program "by comparing the plan's economic effects on a pretax and posttax basis." App. B. at 69a. The court reasoned that while the COLI program was projected to produce a "post-tax" gain, when the tax savings resulting from the deduction of policy loan interest are subtracted, the result is a "pre-tax" loss. The court held that for this reason the COLI plan lacked economic substance, stating that the plan was "economically dependent upon the tax benefits generated by the policy loan interest deductions." App. B. at 70a. The court also held that the COLI program lacked practical economic effects because the policies were "experience rated" to achieve so-called "mortality neutrality" (*i.e.*, policyholder dividends were distributed if actual death benefits paid under the policies were less than what was anticipated when the cost of the insurance was determined). Likewise, the court held that the COLI program lacked economic substance because AEP's policies had so-called "zero net equity" (*i.e.*, AEP took the maximum amount of policy loans available under the policies, so that the amount of the policy loans equaled the policy value of the COLI policies).

In the district court, the government also argued that AEP's policy loans, as well as certain withdrawals and policyholder dividends, were factual shams. The district court found that the policy loans and withdrawals were real but that the policyholder dividends were shams in fact.

6. On appeal, the Sixth Circuit held that "[e]ach individual COLI policy did in fact transfer risk and thereby have economic substance." App. A. at 9a. Nevertheless, the Sixth Circuit affirmed the district court's holding that AEP's overall COLI plan lacked economic substance, stating that because the plan

was projected to yield a pre-tax loss, it "bears the hallmarks of an economic sham." App. A. at 8a. The court also concluded that "the plan was mortality-neutral and had zero net equity at the end of each policy year." *Id.*

The Sixth Circuit stated that the district court's sham in fact finding on policyholder dividends was "questionable." The Sixth Circuit explained that the test for sham in fact is whether a purported transaction actually occurred, and observed that "there is nothing in the record indicating that these transactions did not actually occur." App. A. at 15a. However, because its economic substance ruling was dispositive, the Sixth Circuit declined to rule definitively on the sham in fact finding of the district court.

7. A year ago, this Court denied a petition for certiorari filed by the taxpayer in *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001), *cert. denied*, 535 U.S. 986 (2002). In *Winn-Dixie*, the Eleventh Circuit held that a COLI program lacked economic substance, in reliance on this Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960). However, there are five significant and undisputed distinctions between AEP's facts, on the one hand, and the facts in *Winn-Dixie* and *Knetsch*, on the other. These facts justify this Court's granting AEP's petition for certiorari in order to examine whether recent COLI cases have improperly extended the outer reaches of the economic substance doctrine.

First, the trial court below found that AEP had a bona fide business purpose for purchasing its COLI policies. This is in contrast to *Winn-Dixie* and *Knetsch*, in both of which there was an absence of business purpose. AEP's business use of COLI has been validated by the courts and by its regulators.

Second, the Sixth Circuit below held that each of AEP's COLI policies, considered separately, transfers risk to the insurance company and, thus, has economic substance. App. A at 9a. *Winn-Dixie* lacks this crucial holding, as does

Knetsch. In *Helvering v. Le Gierse*, 312 U.S. 531 (1941), this Court held that risk transfer is the *sine qua non* of insurance, and in *United States v. Consumer Life Ins. Co.*, 430 U.S. 725 (1977), this Court held that *Knetsch* was inapplicable to insurance contracts that transferred risk.

Third, both of the courts below found that AEP's policy loans were real indebtedness, rejecting the government's argument that the policy loans were shams in fact. In contrast, in *Knetsch* the trial court found that no bona fide indebtedness actually existed, and this finding was the foundation for this Court's holding that the *Knetsch* transaction lacked economic substance.

Fourth, in this case the record establishes that the economic results of the AEP COLI program were not predetermined. In contrast, the performance of the plans in *Winn-Dixie* and *Knetsch* were "rigged" or "locked." In AEP's case, every component of the COLI plan (market-based investment results, mortality experience, and expenses) varied from what was initially projected. Indeed, in the first nine policy years, actual earnings were approximately $119 million less than the $146 million of earnings that were projected.

Fifth, the record in this case, unlike the record in *Winn-Dixie*, establishes that under a COLI program, the absence of projected "pre-tax profit" from mortality is natural and expected, and not the result of artifice or manipulation. Assuming normal mortality experience, any large life insurance program projects a loss, because the total insurance charges projected to be paid by the policyholder to the insurance company must exceed the death benefits projected to be paid by the insurance company to the policyholder. If this were not so, the insurance company would fail to earn a profit. This showing, absent in *Winn-Dixie*, reveals the error of using a "pre-tax loss" test to invalidate COLI programs.

8. Moreover, the record below contains important and uncontradicted evidence, not present in *Winn-Dixie*, establishing that the tax subsidy intentionally granted by Congress to the inside buildup, and not the deduction of policy loan interest, provides the key tax benefit obtained by means of a COLI program.

The record below contains proof that the deduction for policy loan interest does not distort the calculation of AEP's taxable income, because that deduction reflects a real payment of interest that actually reduces AEP's economic income. More important, the record contains proof that the deduction of policy loan interest results in no revenue loss to the government when all parties to the transaction are considered. This is because the insurance company reports as taxable income the same policy loan interest that AEP deducts.

The record below establishes instead that the favorable tax consequences obtained by AEP result from the tax exemption granted by Congress to the inside buildup. Because the insurance company reports a deduction for the amounts that it credits as inside buildup, and because those amounts are not taxable to AEP, the inside buildup tax exemption results in a revenue loss to the government. In tax jargon, the asymmetrical treatment of inside buildup (which is deducted from the insurance company's taxable income, but not included in AEP's taxable income) gives rise to both a distortion in the calculation of taxable income and a revenue loss to the Treasury. For this reason, federal budgets annually list the inside buildup tax subsidy as a major tax expenditure. Executive Office of the President, Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government Fiscal Year 1996* at 64 (1995).

REASONS FOR GRANTING THE PETITION

As described above, AEP's COLI policies were commercially available, were approved by state regulators, and transferred insurance risk. The premiums paid, the policy loans taken, the inside buildup credited, and the death benefits received on the COLI policies were bona fide and real. As the government has admitted, the COLI policies and plan have economic "effects on taxpayer, MBL, Hartford, regulators, taxpayer's ratepayers, its VEBA, and employees." Government's Br. at 24. Given these admitted economic effects, and the fact that the COLI policies comply with the detailed statutory regime set forth by Congress in Code §§ 264, 7702 and 7702A, the Sixth Circuit's application of the economic substance doctrine cannot be squared with this Court's decision in *Knetsch v. United States*, 364 U.S. 361 (1960).

Moreover, the Sixth Circuit has created a circuit conflict by holding that the transaction in dispute lacks economic substance because it is profitable only on an "after-tax" basis. Contrary to the decision below, the Ninth Circuit has recognized that when a transaction (such as an investment in solar water heaters under former Code § 44C or the purchase of life insurance) is granted a legislative tax subsidy, the absence of "pre-tax profit" does not demonstrate a lack of economic substance. *Sacks v. Comm'r*, 69 F.3d 982 (9th Cir. 1995); *Shirar v. Comm'r*, 916 F.2d 1414 (9th Cir. 1990).

Finally, since AEP's COLI plan transferred real insurance risk to the insurance company and resulted in the payment of substantial death benefits that admittedly are bona fide, the decision below is at odds with two important insurance tax decisions of this Court. *Helvering v. Le Gierse*, 312 U.S. 531 (1941), established that the presence of risk transfer (admittedly present in AEP's case) is the *sine qua non* of substantive insurance in tax cases. *United States v. Consumer Life Insurance Co.*, 430 U.S. 725 (1977), established that experience rated insurance arrangements (AEP's COLI plan is experience rated)

do not lack economic substance even though, as a result of the experience rating mechanism, the underlying insurance transaction is not expected to produce a "pre-tax" profit. Because experience rating has been addressed and upheld by the Seventh Circuit in *Sears, Roebuck & Co. v. Commissioner*, 972 F.2d 858, 862 (7th Cir. 1992), the decision below also creates confusion and uncertainty as to the proper tax treatment of experience rating, which is a common feature of numerous life insurance products.

This Court's intervention is necessary to prevent an expansion of the economic substance doctrine in a manner that tramples Congress's legislative decisions, extends *Knetsch* well beyond its intended bounds, and ignores other decisions of this Court.

I. The Economic Substance Doctrine Should Not Be Expanded to "Trump" the Detailed Statutory Framework that Congress Crafted to Place Carefully Measured Limits on COLI and Other Life Insurance Policies

Discussions of the economic substance doctrine generally begin with *Gregory v. Helvering*, 293 U.S. 465 (1935), in which the taxpayer claimed to have effected a tax-free reorganization. The Court held that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 469. The Court in *Gregory* held that what was done there was not the type of transaction that Congress intended the statute to cover. Thus, the Court applied the economic substance doctrine by analyzing the disputed transaction in the context of, not apart from, the applicable tax statutes.

In *Knetsch*, the Court applied the economic substance doctrine to the debt-financed purchase of an annuity policy. In the AEP case (and in other leveraged COLI cases), the courts have relied on *Knetsch* in holding that COLI programs lack

economic substance. However, this reliance is erroneous for the reasons that (i) AEP's facts are clearly distinguishable from the *Knetsch* facts, (ii) the *Knetsch* transaction did not take place in the context of an existing statutory framework for the deduction of loan interest, and (iii) AEP's COLI transaction is governed by the detailed statutory framework that Congress constructed after *Knetsch* was decided.

A. Unlike the Individual Taxpayer in *Knetsch*, AEP Had a Business Purpose for Its COLI Program, and AEP's Program Had Significant Economic Effects

The facts surrounding AEP's COLI program are night-and-day different from those in *Knetsch.* First, *Knetsch* involved a transaction without business purpose, whereas the courts and AEP's regulators have acknowledged AEP's business purpose.

Moreover, *Knetsch* involved a transaction without economic effects. First, the trial court in *Knetsch* found factual sham, determining that no bona fide indebtedness actually was created. Second, all economic aspects of the transaction were "locked," *i.e.*, there was no risk that actual experience would cause pre-tax and post-tax results to vary from expected results. Third, the annuity contract did not provide life insurance benefits, so there was no transfer of insurance risk and thus no prospect of gain or loss from mortality. Fourth, the annuity benefits provided by the contract were only $43 per month, which the Court described as a "relative pittance." In sum, in *Knetsch* the loans were factual shams, the transaction was "fixed," there was no prospect of mortality gain or loss, and the annuity benefits at stake were a "pittance." Under those circumstances, the Court correctly held there were no economic effects apart from the claimed tax deductions.

In contrast, the economics of AEP's COLI program were not fixed, and the actual results of the program varied significantly from the results projected. In addition, the courts below held that AEP's policy loans were real and bona fide.

Further, AEP's policies were designed to provide death benefits that would be eight times greater than the anticipated policy loans, and the death benefits paid in the first ten years ($180 million) cannot be characterized as a "pittance." Also, as the government has admitted, the COLI policies and plan had a variety of significant economic "effects on taxpayer, MBL, Hartford, regulators, taxpayer's ratepayers, its VEBA, and employees." Government's Br. at 24.

Finally, it is critical that the Sixth Circuit held that each of AEP's COLI policies transferred insurance risk. In *Le Gierse*, this Court held that insurance exists when risk is transferred. In *Consumer Life*, relying on the existence of transfer of insurance risk, this Court held that *Knetsch* was inapplicable and rejected the government's argument that "reinsurance agreements were sham transactions without economic substance. . . ." 430 U.S. 725 at 736-37. In *Winn-Dixie* and the other COLI cases, there was no finding that the life insurance policies transferred risk. In this case, the Sixth Circuit held that there was transfer of risk, and its conclusion that, nevertheless, economic substance was lacking is erroneous and is in tension with this Court's decision in *Consumer Life*.

B. In Contrast to *Knetsch*, the AEP Tax Controversy Does Not Arise in a Statutory Vacuum

In *Knetsch*, the taxpayer purchased a single-premium annuity and incurred the sham indebtedness in 1953, at which time no provision of the Code was applicable to the transaction. While Congress had amended Code § 264 in 1954 to disallow interest deductions on debt incurred to purchase single-premium life insurance contracts, it did not extend that provision to single-premium annuities until 1955. Thus, the *Knetsch* Court applied the economic substance doctrine in a statutory vacuum.

In *Knetsch*, the taxpayer contended that Congress's subsequent enactment of an anti-annuity loan rule should create a negative inference that Congress approved of pre-enactment

Knetsch-type transactions "without regard to whether the transactions created a true obligation to pay interest." 364 U.S. 361 at 367. The Court rejected this theory, holding that the taxpayer could not retroactively attribute congressional intent in this manner. AEP makes no similar, retroactive argument. AEP contends that the statutes that apply directly to its transaction (*i.e.*, Code §§ 264, 7702, and 7702A) authorize its conduct.

In various cases subsequent to *Knetsch*, the economic substance doctrine likewise was applied in a statutory vacuum. All of those cases involved pre-1964 transactions, which were not covered by any of the subsequently adopted statutory enactments applicable to AEP's transaction. In certain of these cases, the government prevailed. *Golsen v. Comm'r*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) ("*Golsen I*"), *cert. denied*, 404 U.S. 940 (1971); *Goldman v. United Sates*, 403 F.2d 776 (10th Cir. 1968); *Ballagh v. United States*, 166 Ct. Cl. 191 (1964), *cert. denied*, 379 U.S. 887 (1964). In other cases, the taxpayer prevailed. *Woodson-Tenent Labs. Inc. v. United States*, 454 F.2d 637 (6th Cir. 1972); *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967); *Coors v. United States*, 572 F.2d 826 (Ct. Cl. 1978); *Priester Mach. Co. v. United States*, 296 F. Supp. 604 (W.D. Tenn. 1969). These cases illustrate the courts' confusion in interpreting *Knetsch* and applying the economic substance doctrine to life insurance.

The bottom line is that AEP's situation is far different from the situations of the taxpayers in *Knetsch* and its progeny. In AEP's case there is no statutory vacuum left for the economic substance doctrine to fill. Instead there are multiple provisions that reveal and effectuate Congress's intent to regulate various aspects of the COLI program, and the courts below have applied the economic substance doctrine in the face of, and in a manner that wrongly displaces, that statutory regime.

C. AEP's COLI Program Is Governed by the Detailed Statutory Framework that Renders *Knetsch* "Moot," and the Economic Substance Doctrine Inapplicable

As described above, in *Knetsch* and its progeny the courts applied the economic substance doctrine in a statutory vacuum. In those cases, there was no statutory regulation of the transactions, and no congressional intent indicating that Congress authorized or approved the transactions. AEP's situation is totally opposite, and the existence of post-*Knetsch* statutes — which regulate AEP's transaction in great detail and authorize the claimed interest deductions — evidence congressional approval of its transaction, making the economic substance doctrine inapplicable. As will be seen, **the government itself** previously made this very argument to this Court.

In *Golsen I*, the taxpayer's COLI policies were purchased before 1964, so that the "systematic borrowing" rule of Code § 264, and that rule's "4-out-of-7" borrowing exception, were inapplicable. In *Golsen I*, the Tax Court and the Tenth Circuit, citing *Knetsch*, held that the taxpayer's transaction lacked economic substance. The taxpayer petitioned for certiorari following its loss in the Tenth Circuit, asking this Court to review the split that had developed in the circuits over the application of *Knetsch* to life insurance policy purchases. The government filed a brief in opposition to the petition, in which it noted that Congress had amended Code § 264 permitting COLI purchases in accordance with the "4-out-of-7" borrowing exception. On the basis of that amendment to Code § 264, the government on brief stated to this Court that, while a circuit conflict existed, "the issue presented has been **rendered moot** with respect to contracts entered into after August 6, 1963" (emphasis added). Government's Opp'n. at 5.

Thus, based on a single amendment adding the "4-out-of-7" borrowing exception to Code § 264, the government recognized in its brief filed in this Court that application of an expanded economic substance doctrine thereafter was unwarranted. The government's position undoubtedly was correct. When Congress enacted the 1964 amendment, it described "minimum deposit" plans similar to AEP's, in which the policyholder "borrows all, or a substantial part, of the funds necessary to pay the premium on the policy."[4] Congress noted that (assuming a 50 percent tax rate) "the interest payments on such loans are presently deductible, [so that] the net interest cost to him [*i.e.*, the policyholder] is one-half or less of the interest payments he makes." *Id.* at 61. Congress also noted that the "annual increase in the cash value of the insurance policy to reflect interest earnings [*i.e.*, the inside buildup], which generally is not taxable to the taxpayer either currently or otherwise, is likely to equal or exceed the net interest charges the taxpayer pays." *Id.* As a result, Congress concluded that "where the annual increment in the value of the policy, apart from the premiums, exceeds the net interest cost of the borrowing, such policies can actually result in a net profit for those insured." *Id.*

The importance of Congress's observations cannot be denied. In these few sentences, Congress recognized that COLI purchases on a "minimum deposit" basis — like AEP's — produce a pre-tax loss, but are profitable on a post-tax basis. This fact of pre-tax loss is the critical fact that the courts below relied upon to find that AEP's COLI plan lacked economic substance, with the result that the interest deductions were completely disallowed. However, despite Congress's recognition of the fact that debt-financed life insurance produces a pre-tax loss and a post-tax gain, Congress's response was not to disallow the interest deduction completely, but rather to allow the deduction of interest subject to limits. In enacting the

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4. H.R. Rep. No. 88-749 at 61 (1963).

"4-out-of-7" borrowing exception, Congress explained that "it has been careful in this provision to provide for **the retention of rights to borrow** on insurance for other than tax-saving purposes **without the loss of the interest deduction**" (emphasis supplied). *Id.* at 61-62.[5] Accordingly, in its brief in opposition in *Golsen I* the government correctly recognized that Congress's 1964 amendment of Code § 264 displaced the *Knetsch*-type economic substance doctrine in the context of leveraged COLI plans. Government's Opp'n. at 5.

Since the time of that statement by the government, Congress has enacted three additional statutory refinements. As described above, in 1984 Congress enacted Code § 7702; in 1986 Congress amended Code § 264 to cap borrowing at $50,000 per insured (specifically for COLI); and in 1988 Congress enacted Code § 7702A. All three of these statutory amendments were designed to further regulate the purchase of COLI policies on a "minimum deposit" basis.

In 1964, and when Congress enacted each of these three subsequent provisions, it was acutely aware of the tax advantages accorded to debt-financed life insurance policy purchases. For example, in 1983, Congress pointed out the existence of "minimum deposit" purchase plans and noted that "[a]lthough these plans literally fall within the [Code § 264] safe harbor rules, an investor can obtain substantial tax sheltering of outside income through tax-deductible policy loan interest payments that are funded primarily through tax-free investment earnings on a policy."[6] After thus recognizing the phenomenon of a pre-tax loss and a post-tax gain, Congress stated that "the need for any safe-harbor rules arguably should be reexamined." *Id.*

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5. As noted above, the courts below found that AEP had a valid non-tax business purpose for its COLI program.

6. Joint Committee on Taxation and Senate Committee on Finance, 98th Cong., *Major Issues in the Taxation of Life Insurance Products, Policyholders, and Companies* 25 (Jt. Comm. Print 1983).

Like the 1964 statutory refinement, the 1984, 1986 and 1988 statutory refinements are all important to this Court's consideration of this petition. In its brief in opposition in *Golsen I*, the government told this Court that the application of *Knetsch* and the economic substance doctrine to debt-financed COLI purchases was "rendered moot" based on the enactment in 1964 of a statutory provision with which AEP's policies are in compliance. By the time that AEP purchased its COLI policies, Congress again had considered the question of "minimum deposit" life insurance purchases and enacted three additional statutory amendments. AEP's COLI policies are in compliance with these three amendments. The government recognized in *Golsen I* that *Knetsch* and the economic substance doctrine were displaced subsequent to the 1964 amendment. A fortiori, *Knetsch* and the economic substance doctrine do not apply in the context of AEP's COLI policies, which are regulated by, and comply with, not only the 1964 amendment, but with the three subsequent statutory refinements as well.

In sum, the existence of Congress's statutory regime for debt-financed COLI purchases is crucial because the existence of those detailed requirements demonstrates that Congress intended to permit debt-financed COLI purchases, subject to its enacted restrictions. Unlike the situation in *Knetsch*, *Golsen I*, and related cases, in AEP's case there is no statutory vacuum in which the economic substance doctrine can be applied. Here, there is a detailed statutory regime, enacted by Congress over the years, and the application of an expanded economic substance doctrine frustrates Congress's intent in crafting this statutory regime.

II. The Presence of a Projected Economic Pre-Tax Loss Does Not Prove that a Transaction Lacks Economic Substance

The government's position, adopted by the Sixth Circuit below, is that for AEP's COLI plan to have economic substance, the plan must produce a pre-tax gain. Specifically, the Sixth

Circuit held that because AEP's COLI plan was projected to yield a "pre-tax loss," it "bears the hallmarks of an economic sham." App. A. at 8a. This position is legally incorrect, and is in conflict with the decisions of other circuit courts of appeals.

A. The Sixth Circuit's Decision Creates a Circuit Conflict By Equating "Pre-Tax Loss" with a Lack of Economic Substance

This Court has held that the fact that "favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences." *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978). As this Court also stated in *Consumer Life* in connection with tax-induced reinsurance treaties, "[t]ax considerations well may have had a good deal to do with the specific terms of the treaties, but even a 'major motive' to reduce taxes will not vitiate an otherwise substantial transaction." 430 U.S. at 739. In this case, AEP obviously was aware of the tax advantages permitted by Congress to be obtained through the purchase of life insurance policies on a debt-financed basis. However, AEP had a valid business purpose for the transaction, and its COLI plan produced a myriad of significant economic consequences.

In the context of debt-financed purchases of life insurance, the "pre-tax gain" standard is particularly inappropriate. The record below contains proof establishing that a projected, pre-tax loss is a natural consequence of any life insurance transaction. When a life insurance company issues a life insurance policy, it charges for its expenses, and it prices the policy to earn a profit. The consequence of these elements of expenses and profit is that the life insurance company expects to gain, with a corresponding loss to the policyholder. If this were not so, insurance companies would soon go out of business. As the Eleventh Circuit has stated, "[i]nsurance companies indeed do not make a habit of issuing policies whose premiums do not exceed the claims anticipated." *United Parcel Serv. v.*

Comm'r, 254 F.3d 1014, 1018 (11th Cir. 2001). This proof that a projected pre-tax loss is a natural consequence in all life insurance purchases is significant, because it establishes that requiring pre-tax gain in order for economic substance to exist is a test that disqualifies all life insurance purchases. If this were the test, Congress's enactment of Code §§ 264, 7702 and 7702A would be rendered meaningless.

The pre-tax loss analysis used by the court below creates a clear conflict between this case and the Ninth Circuit's decision in *Shirar v. Commissioner*, 916 F.2d 1414 (9th Cir. 1990). Initially, it is important to understand that in *Knetsch*, the "pre-tax loss" produced by the annuity transaction was converted into "post-tax gain" by the allowance of interest deductions. In contrast, in AEP's case, for the majority of policies in any year (*i.e.*, those on which no death benefit was paid), AEP incurred both a "pre-tax loss" and a "post-tax loss." This is because, unlike the *Knetsch* annuity policy (and like the *Shirar* life insurance policy), AEP's COLI policies provide substantial life insurance benefits, for which AEP pays cost of insurance charges. For these policies, the resulting "pre-tax loss" cannot be converted into a "post-tax gain" by the allowance of policy loan interest deductions. AEP's situation is identical to that in *Shirar*, also a case involving the debt-financed purchase of life insurance policies. There, the Ninth Circuit held that *Knetsch* was distinguishable, stating that "even if the Commissioner had allowed the interest deductions claimed . . . Shirar would have still had a net out-of-pocket expense [*i.e.*, a "post-tax loss"]. . . ." 916 F.2d at 1418. In contrast, allowance of the interest deductions involved in *Knetsch* would have resulted in a net gain [*i.e.*, a "post-tax gain"]. Accordingly, in conflict with the decision below, the Ninth Circuit held that *Knetsch* did not apply and that the life insurance transaction possessed economic substance.

By equating the existence of a pre-tax loss with a lack of economic substance, the court below also has created an

additional multi-circuit conflict. In *Maysteel Products, Inc. v. Commissioner*, 287 F.2d 429 (7th Cir. 1961), and *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961), the courts considered tax-induced bond purchase transactions. The Seventh and First Circuits held that the transactions, even though they had no potential for pre-tax profit, were genuine transactions and not "shams." As in AEP's case, the taxpayers in *Maysteel* and *Fabreeka* entered into transactions that produced significant economic consequences. However, in conflict with the decision below, the *Maysteel* and *Fabreeka* courts refused to invalidate those transactions even though they were profitable only on a post-tax basis.

B. The Circuits Are Applying Conflicting Standards to Evaluate the Economic Substance of Transactions that Receive "Tax Preferred" Treatment

With respect to AEP's COLI policies, the event necessary to turn a "pre-tax loss" into a "post-tax gain" was the receipt of death benefits. The fact that only the receipt of death benefits could transform a "pre-tax loss" into a "post-tax gain" leads to an additional circuit conflict. As described above, Congress intentionally granted a tax subsidy to the "inside buildup" in life insurance policies, thereby creating an incentive for taxpayers to purchase life insurance policies on a debt-financed basis. AEP's COLI policies complied with all of the tax statutes enacted by Congress to regulate the availability of this tax subsidy (Code §§ 264, 7702 and 7702A). In *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995), the Ninth Circuit held that when an important element of a transaction consists of a legislative tax subsidy, it is wrong to evaluate the economic substance of the transaction on a "pre-tax" basis, *i.e.*, through a test that ignores the value of the intended tax subsidy. The Ninth Circuit stated that a tax-subsidized transaction does "not become a sham just because its profitability was based on after-tax instead of pre-tax projections." *Id.* at 991. The Sixth Circuit below expressly rejected *Sacks*, and held that it would not

evaluate the transaction's profitability on a post-tax basis.[7] App. A. at 11a. The Sixth Circuit's holding is erroneous as a matter of law, and creates a clear conflict in approach with the Ninth Circuit's decision in *Sacks*.[8]

III. The Sixth Circuit's Application of the "Mortality Neutrality" Concept Conflicts with Decisions of This Court and of Several United States Circuit Courts of Appeals

The phrase "mortality neutrality" employed by the court below simply refers to the fact that the COLI plan was experience rated. This means that the insurance company returned as policyholder dividends any excess insurance charges, so that over time the insurance charges retained by the insurance company were expected (but not guaranteed) to approximate the death benefits and the experience refunds (*i.e.*, dividends) paid by the insurance company to AEP, minus a fee equal to about two percent of insurance charges. That fee reimbursed the insurance company for costs of administering the COLI plan, and compensated the insurance company for the risk that there might be catastrophic losses.

The same functional fact, *i.e.*, insurance neutrality, was present in *Consumer Life* in a reinsurance context. There, the insurance company providing the reinsurance

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7. As one scholar recognized over twenty years ago, "the requirement of pretax profit is not likely to play a useful role in [applying the economic substance doctrine to] transactions which are what they purport to be and which involve tax provisions that were specifically enacted to significantly affect taxpayer investment decisions." Alvin C. Warren, Jr., *The Requirement of Economic Profit In Tax Motivated Transactions*, 59 Taxes 985, 991 (Dec. 1981).

8. The Sixth Circuit below also attempted to distinguish *Sacks* on the factual ground that AEP's plan was "mortality neutral." We discuss this point below.

(the reinsurer) was credited with 100 percent of the underlying policy premium. 430 U.S. 725, at 734. Initially, the reinsurer returned 50 percent of that premium to Consumer Life (the reinsured) for use in paying expenses. With respect to the remaining 50 percent of premium, the reinsurer retained three percent as its fee, covering its expenses plus the cost of assuming the risk of catastrophic loss (admitted not to be likely). The remaining 47 percent of the premium was returned to Consumer Life in the form of claim payments and experience refunds.

The similarities to AEP's facts are striking. First, the reinsurance program was projected and designed to produce a pre-tax loss for Consumer Life, which paid 100 percent of the policy premiums to the reinsurer and expected a return equal to 97 percent of such premiums. While the actual paid claims could vary, the experience refund feature was used to offset such variations and obtain that anticipated result. Second, Consumer Life had business reasons in addition to tax motivations to enter into the transaction. Third, the reinsurance transaction transferred risk to the reinsurer, at least to the extent that the reinsurer assumed the risk of catastrophic losses. Fourth, the favorable tax treatment at issue was plainly set forth in controlling statutes that the government sought to sidestep, relying on an expansion of *Knetsch*. Despite the presence of a pre-tax loss (equal to the three percent of premiums retained by the reinsurer), this Court ruled that *Knetsch* and the economic substance doctrine did not render the transaction invalid for tax purposes. The Court based its decision on the presence of insurance risk transfer coupled with a business purpose, both of which exist in AEP's case. The Court held that the presence of tax motivations was irrelevant. The decision below is in conflict with *Consumer Life*.

Experience rating and other mechanisms are commonly used to reduce mortality variation. In *Sears, Roebuck & Co.*, 972 F.2d at 862, the Seventh Circuit stated that "[m]uch

insurance sold to corporations is experience-rated." The court noted that, under these experience rating mechanisms,

> bounds are set so that almost all of the time the insured firm pays the full costs of the losses it generates. Both experience rating and retrospective rating attempt to charge the firm the full cost of its own risks over the long run, a run as short as one year with retrospective rating.

Id. at 862. The Seventh Circuit concluded that use of an experience rating mechanism to "charge the firm the full cost of its own risks" (*i.e.*, to achieve mortality neutrality), *id.*, does not deprive the insurance arrangement of economic substance, and the Sixth Circuit's decision below conflicts with the Seventh Circuit's holding in *Sears*.

Moreover, the court below was wrong to suggest that AEP's mortality experience under its COLI plan was predetermined to be neutral, without the possibility of gain or loss. In fact, during the term of its policies, AEP experienced gains in some years and losses in others.[9] Moreover, there is no provision in the COLI policies that deprives AEP of the opportunity to enjoy mortality gain at the insurance company's expense. If AEP were to receive greater death benefits than projected, AEP could preserve that mortality gain by canceling its remaining policies, by exchanging those policies for policies issued by another insurance carrier, or by reducing the amount of insurance in force.

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9. The record below establishes that among AEP's subsidiaries that purchased COLI policies, some experienced mortality gains while others experienced mortality losses. Because most of these subsidiaries served different customer groups, and were subject to different ratemaking environments, these variations in mortality experience produced varying economic effects on the ratepayers of each subsidiary. The Sixth Circuit's decision below that this differing subsidiary-level experience is irrelevant conflicts with this Court's holding in *Frank Lyon*, which establishes that third party impacts are indicative of economic substance.

Finally, the Sixth Circuit's "mortality neutrality" holding is erroneous given its recognition that in AEP's plan "each individual COLI policy did in fact transfer risk and thereby have economic substance." App. A. at 9a. The only appropriate analysis is that the economic substance of each individual policy conclusively determines the economic substance of the COLI plan as a whole. In *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991), a savings association exchanged its interest in one pool of mortgage loans for an interest in another pool. Individually, the mortgage loans in the pools had different obligors and embodied "legally distinct entitlements." *Id.* at 566. Despite these individual differences, the government contended that the interests in the two mortgage pools, in the aggregate, did not "differ in economic substance." *Id.* at 562. This Court rejected that argument, holding that the economic substance analysis must occur on the level of the individual mortgages, and not in the aggregate at the level of the mortgage pools. The Sixth Circuit's decision below, which ignores the economic substance of the individual policies, and determines economic substance in the aggregate, is erroneous and in conflict with this Court's conclusion in *Cottage Savings*.[10]

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10. Ultimately, the Sixth Circuit's aggregate "mortality neutrality" analysis is simply a conclusion that AEP's 20,000-policy COLI plan is too large. However, the tax year in issue here is 1996. For that year, in the TAMRA legislation, Congress enacted a transition rule allowing reduced interest deductions for policy loans with respect to a maximum of 20,000 insured lives per policyholder. This transition relief establishes that Congress believed that plans the size of AEP's should not be denied the treatment accorded to smaller plans and to individual policies.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted,

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